Internal Revenue Service

memorandum

CC:TL-N-5931-89
Br4:JRDomike

date: JUL 14 1989

to: Deputy Regional Counsel (GL), Western Region CC:W

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted] Commerciality Issue

This responds to your memorandum of April 18, 1989, requesting tax litigation advice regarding a legal issue. The issue as framed therein is:

> Assuming that the Service found no evidence of inurement or violation of public policy and that the facts as stated in their supplemental submission [1/] to the National Office were verified by the Service as true and correct and that the Service found no other evidence to show that the Church's operation was for a substantial non-exempt commercial purpose, and that the Church remained committed to its fixed fee policy, would the Service still deny it exemption [under section 501(c)(3) of the Internal Revenue Code]?

We believe that the question being asked is whether, in the current examination of Church [redacted] (pursuant to section 7611 of the Code), operation for a substantial non-exempt commercial purpose is still an issue? We conclude that the answer is yes, it is.

APPLICABLE LAW

An organization that qualifies as an organization described in section 501(c)(3) of the Internal Revenue Code is exempt from federal income taxation pursuant to section 501(a). Furthermore, contributions and gifts to the organization may be deductible for income tax (section 170(c)(2)), estate tax (section 2055(a)(2)), or gift tax (section 2522(a)(2)) purposes.

1/ "Supplemental submission" refers to post-conference information provided by Church [redacted] and [redacted] as part of their applications for recognition of tax exemption. The contents of the supplemental submission are listed as Part IV of the Index to Administrative Record filed with the United States Claims Court in Church of Spiritual Technology v. United States, No. 581-188T.

Section 501(c)(3) describes, in pertinent part, organizations organized and operated exclusively for charitable, religious or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that if an organization fails to meet either the organizational or the operational test, it is not exempt. The issue examined here is whether the organization satisfies the operational test--whether it is operated exclusively for exempt purposes.

"Exclusively" is a term of art. Easter House v. United States, 12 Cl. Ct. 476, 483 (1987), 87-1 USTC ¶ 9359, aff'd w/o published opinion, 846 F.2d 78 (Fed. Cir. 1988), cert. denied, 109 S.Ct. 257 (1988). The word "exclusively" places a definite limit on the "purpose" at issue. Copyright Clearance Center v. Commissioner, 79 T.C. 798, 804 (1982). As articulated by the Supreme Court in Better Business Bureau v. United States, 326 U.S. 279, 283 (1945)--

> the presence of a single [non-exempt] ... purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] ... purposes. [Emphasis supplied.]

As expressed in the regulations, an organization is regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). Treas. Reg. § 1.501(c)(3)-1(c)(1). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Id.

As noted by the Tax Court, the quotation from Better Business Bureau relates to "purpose" while the regulation deals more with "activities." Christian Manner International v. Commissioner, 71 T.C. 661, 668 (1979). Under the rationale of Better Business Bureau the existence of a substantial non-exempt purpose for a corporation's organization and existence would appear to defeat the exemption. But under the regulation even if there was no non-exempt purpose for the organization and existence of the entity, it must actually engage primarily in activities which accomplish one of the exempt purposes, and if more than an insubstantial part of its activities do not further such exempt purpose, the entity is not exempt. Id. at 668. The analysis must concern both the actual as well as the stated purposes for the existence of the organization and the activities

it engages in to accomplish these purposes. What those purposes are and what purposes the activity or activities engaged in support are questions of fact. Id.

Weighing the importance of the exempt purpose against the substantial non-exempt purpose is not the test. Christian Manner International v. Commissioner, supra at 665. But consideration must be given to whether the non-exempt purpose is independent of, or merely incidental to, the exempt purpose or purposes. Id. at 665-666.

It is possible for one activity to be carried on for multiple purposes. B.S.W. Group, Inc. Commissioner, 70 T.C. 352, 357 (1978); cf. Better Business Bureau, Inc. v. United States, 326 U.S. 279, 283-284 (1945). If the organization engages in an activity which may have multiple purposes, the question is whether it engaged in this activity exclusively for exempt purposes or whether, in so doing, it is "animated" by a substantial non-exempt purpose. Better Business Bureau, Inc., supra. Where a non-exempt purpose is not an expressed goal, courts have focused on the manner in which activities themselves are carried on, "implicitly reasoning that an end can be inferred from the chosen means." Presbyterian & Reformed Publishing Co. v. Commissioner, 79 T.C. 1107, 1082-1083 (1982), reversed on other grounds, 743 F.2d 148 (3rd Cir. 1984).

If an organization's management decisions replicate those of commercial enterprises, it is "a fair inference" that at least one purpose is commercial, and hence non-exempt. And if this non-exempt goal is substantial, tax-exempt status must be denied. Id. Factors such as the particular manner in which an organization's activities are conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits are relevant evidence of a commercial purpose. B.S.W. Group, Inc. v. Commissioner, supra, 70 T.C. at 357.

Where prices are fixed to return a profit, the courts consider it some evidence of a commercial purpose. Christian Manner International v. Commissioner, supra, 71 T.C. at 670. Profits may be realized or other non-exempt purposes may be necessarily advanced incidental to the conduct of the activity, but the existence of such non-exempt purposes does not require denial of exempt status so long as the organization's dominant purpose for conducting the activity is an exempt purpose, and so long as the non-exempt commercial activity is merely incidental to the exempt purpose, and not conducted in substantial degree for the purpose of making profits. Greater United Navajo Enterprises v. Commissioner, 74 T.C. 69, 78-79 (1980), aff'd without opinion, 672 F.2d 894 (9th Cir. 1981).

Unexplained accumulations of cash may properly be considered as evidence of commercial purpose. Incorporated Trustees of the Gospel Worker Society v. United States, 510 F.Supp. 374, 378-379 (D. D.C. 1981), aff'd without opinion, 672 F.2d 894 (D.C. Cir. 1981), cert. denied, 456 U.S. 944 (1982); Presbyterian & Reformed Publishing, supra, 743 F.2d at 157.

A non-profit organization licensed by for-profit entities may be operated for a commercial purpose. est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), aff'd without opinion, 647 F.2d 170 (9th Cir. 1981). In that case, the court found that the educational organization was part of a franchise system operated for private benefit and that its affiliation with the system tainted it with a substantial commercial purpose. Id. at 1080.

The existence of a "substantial commercial purpose" of [redacted] was found by the Tax Court in [redacted]. The "tests" used by the Tax Court, according to one commentator, were (1) the "commercial hue" of the activities, (2) the existence and amount of accumulated profits, (3) the charging of fees for services, (4) the organization's pricing policies, (5) its promotional efforts, (6) the presence of cash reserves, and (7) the fact of contractual arrangements. B. Hopkins, The Law of Tax-Exempt Organizations (5th ed. 1987), § 11.3 at 238. See infra, pages 5-8.

ADVERSE RULING

[redacted].2/ It applied to the Service for tax exemption as a section 501(c)(3) organization. The Service's final adverse ruling (dated [redacted]) (copy attached) states as a disqualifying factor, "You are operated for a substantial non-exempt commercial purpose." The purpose there referred to is "maximizing sales of goods and services associated with the practice of [redacted]." The ruling states further:

> In your protest and subsequent submissions you argued that your activities were engaged in for religious rather than commercial purposes. You contended that the provision of goods and services for a fee, [redacted], was a

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2/ See adverse ruling letter dated [redacted] (copy attached).

permissible means of providing funds necessary for [redacted] to support its operations, provide reserves for renovations and expansion, and to attract potential new members to the religion.

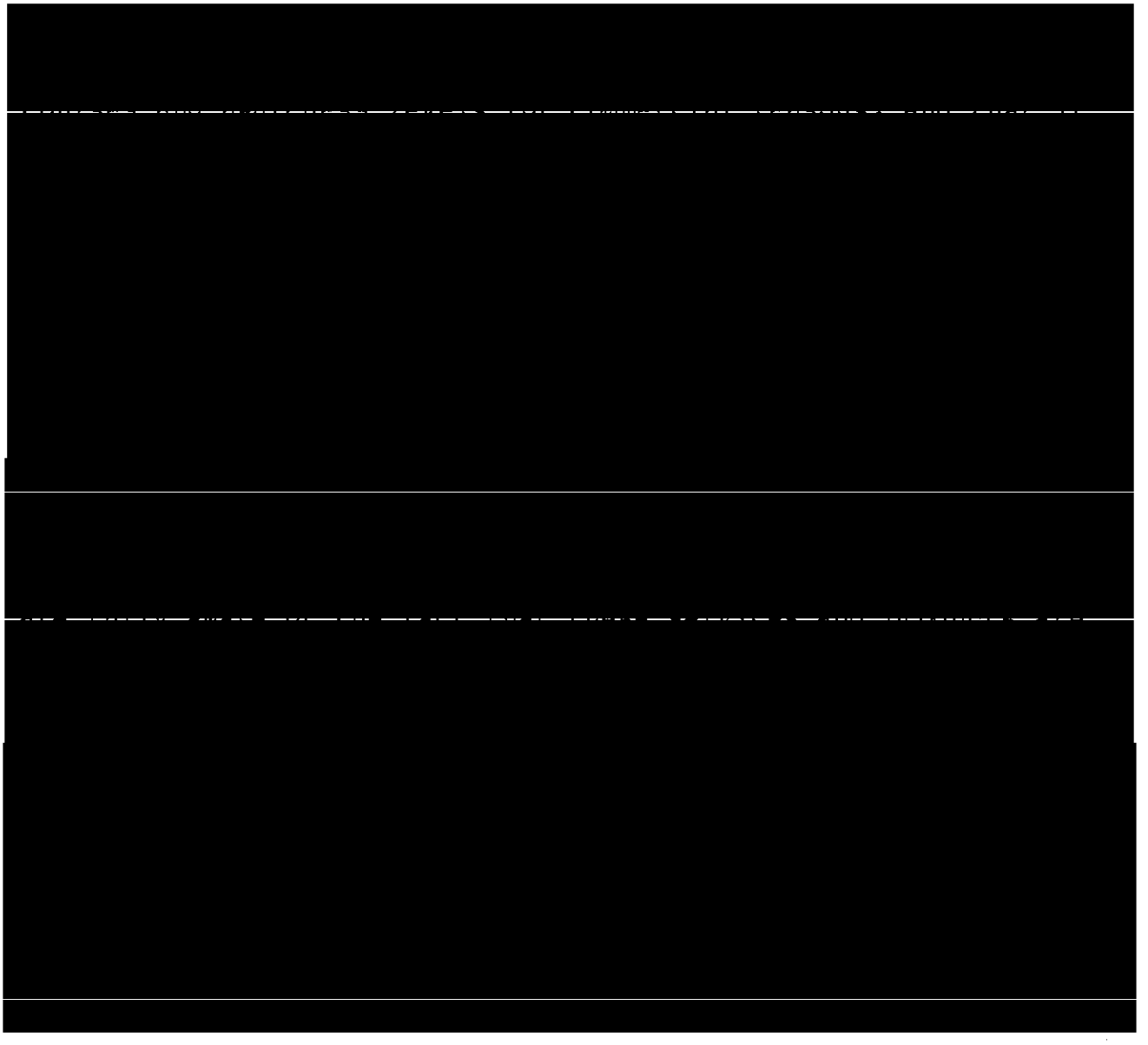
We have carefully considered your arguments, but fail to see that sales of goods and services for a fee by [redacted] organizations under policies and directives which emphasize sales and profits does not result in a primary purpose of engaging in activities similar in nature to those of an ordinary commercial enterprise, in which profits are the primary goal, rather than in advancing religious purposes. The fact that the fees provide a source of funds for operating expenses and future expansion and dissemination does nothing to distinguish these fee-for-service operations from similar activities of ordinary commercial enterprises. Therefore, by assisting and aiding in the marketing of [redacted], you are engaged in activities which further a substantial non-exempt commercial purpose.

The adverse ruling alludes to court cases wherein the exemptions of churches [redacted] had been revoked.

In [redacted], and [redacted], the Service found and the courts agreed that the entities' net earnings inured to the benefit of [redacted].

In [redacted] the Tax Court also found that the church did not merit [redacted] status because some of its operation was in contravention of well-established public policy. In addition, the Tax Court found that the church was not exempt because it had a [redacted]. The Ninth Circuit Court of Appeals affirmed on the ground of [redacted].

[redacted]



The church claimed (as it continues to do) "the right to carry on church-sponsored commercial activity." [redacted]. Specifically, the church complained that it could not make a profit, accumulate earnings, sell religious literature, advertise, or remunerate its founder without losing its exemption by running afoul of the commercial purpose limitation that has been read into section 501(c)(3). Id. at [redacted].

The Tax Court noted that section 501(c)(3) incorporates the requirements of First Amendment tolerance for commercial activity in aid of religion. "A religious organization," it said, "can maintain its exemption and engage in commercial activity,

provided it is incidental to its religious purpose. The exemption is only lost when church-sponsored commercial activity takes on a life of its own and assumes an independent importance and purpose." Id.

The church argued that the commercial purpose restriction hurts newer religions since they must rely on commercial techniques to attract members, propagate their faith, and raise income, whereas older religions already have public recognition, established coffers, and a body of followers. Id. at [redacted]. To this, the Tax Court responded, "[W]e are convinced that the commercial purpose test does not rest on sectarian favoritism for established religions but instead has its basis in charitable trust law which requires charitable organizations to eschew commercialism in favor of serving goals designed to benefit the community at large." Id. at [redacted].

The court pointed out that records have to be examined and some judgments made about the purpose of the organization's programs, receipts, and expenses. "However," it said, "[the Commissioner] does not have to sit as a religious expert. His task is to judge whether the records evince a primary commercial purpose. Equally as important, [he] does not have to make determinations about each and every item of receipt or expense since Section 501(c)(3) permits some commercial activity. ..." 3/ Id. at [redacted].

3/ At this point, the opinion goes on to state, "The loss of an exemption comes about only when the church's activities in the aggregate reflect a primary purpose to engage in private enterprise." [redacted]. We believe this is an inaccurate statement of the rule; rather, "primary" should read "substantial." Copyright Clearance Center, Inc. v. Commissioner, 79 T.C. 793 (1982). As we note in the text, the court, in further elucidating the rule, correctly relied on the "substantial purpose" test. Id. at [redacted]. [redacted]

Compare Treas. Reg. § 1.501(c)(3)-1(e), which states that an organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513.

The court explained that the "exclusively religious" condition has been construed to mean that a substantial part of the organization's activities cannot serve a commercial purpose and that the following factors are to be considered in applying the test: amount of annual profits, amount of accumulated reserves, method of operation, competition with like services in private enterprise, proportion of expenditures devoted to exempt purposes. Id. at [redacted]. The church could not qualify for exemption if its activities were "animated" by a substantial commercial purpose. Id. at [redacted].

[redacted]

The Tax Court subsequently held that payments to the Church [redacted] for [redacted] 4/ are not deductible as charitable contributions because the individuals received the [redacted] as a quid pro quo in exchange for the payments. [redacted]. A motion for rehearing has been filed but has not yet been acted upon by the Court.

In its findings of fact in [redacted], the Tax Court noted that "the Church [redacted] operates in a commercial manner in providing these religious services." [redacted] It further noted:

4/ The Service has three outstanding revenue rulings regarding denial of income tax deductions for payments related to [redacted] practices: Rev. Rul. 78-188, 1978-1 C.B. 40 (amounts paid to the Church [redacted] by a member who is not a minister or employee for "[redacted]" and [redacted] courses that would qualify the member to be an "[redacted]" are expenditures made for education that will lead to qualification in a new trade or business and are not deductible under section 162(a) of the Code); Rev. Rul. 78-189, 1978-1 C.B. 68 (a "fixed donation" paid to the Church [redacted] for general education courses, religious education courses, and "[redacted]" and [redacted] courses that does not exceed the fair market value of these courses is not a charitable contribution within the meaning of section 170 of the Code); Rev. Rul. 78-190, 1978-1 C.B. 74 (amounts paid to the Church [redacted] for a course of [redacted] by a taxpayer who believed that the [redacted] could and did cure [redacted] are not expenses paid for medical care within the meaning of section 213 of the Code).

[redacted]

Id. at [redacted].

In the opinion denying deductibility of the payments made and rejecting [redacted]'s constitutional arguments (id. at [redacted]), the Tax Court did not express reliance on commerciality. The case stands for the proposition that where there is a quid pro quo in the exchange, there has been no deductible contribution or gift.

The Supreme Court's opinion in [redacted] fully supports the findings of the Tax Court. In the opinion, the Court reviews in detail the facts as found by the lower court. [redacted] And, where it upholds the central finding on quid pro quo, the Court returns to and reiterates the distinguishing facts of the case:

[redacted]

[redacted]

By means of these references to the record, the Court highlights the commercial aspects of [redacted] operations.

[redacted]

Preliminarily, it has not been established that [redacted] and other [redacted] churches now operate differently from the periods involved in the court cases. Clearly, there was inurement to [redacted]. For the [redacted] years, the organizations have not dispelled our concern that the possibility for inurement or private benefit exists. Certain [redacted], and [redacted], briefly mentioned in response to requests for information and then never explained, continue to offer the possibility that inurement and/or operation for private benefit exists. (See adverse ruling letter dated [redacted].)

Most important for this discussion is the fact that the organizations have not offered convincing evidence that [redacted] is not still operated for a substantial commercial purpose. Their efforts have instead been directed to minimizing the legal effect of this factual situation. While it is true that the [redacted] case was affirmed by the [redacted] Circuit on inurement grounds, the opinion of the Tax Court on commerciality 5/ is outstanding and has not been refuted.6/ Thus, there is no basis at the present time for the

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5/ "Commerciality" and "commercialism" appear to be interchangeable as short-hand representations of "operation for a substantial commercial purpose." "Commercialism" means" (1) commercial spirit, institutions, or methods; (2) excessive emphasis on profits or financial success." Webster's 3rd New Internat. Dictionary. "Commerciality" means "commercial quality", and "commercial" means "(2a) having profit as the primary aim." Id.

6/ The case is criticized in [redacted]. But two of the opinions relied on in the text were subsequently reversed by the

(continued...)

Service to consider commerciality as anything but a live issue with [redacted] organizations worthy of development for the administrative record.

According to the memorandum dated February 9, 1989, attached to your memorandum, [redacted] does not represent that it has changed the practices upon which the Tax Court found operation for a substantial commercial purpose. It reports that--

Such a confused statement leaves us up in the air as to whether there has been any change or not, and if so, in what direction. What must be emphasized is the overriding importance of establishing what the operations of the church consist of in the period under examination. Emphasis solely on the fixed-fee policy as demonstrating a substantial non-exempt commercial purpose is incomplete and misleading since this is only one factor.

Evidence of commerciality--that is, profit-seeking--would lend support to a finding of inurement and/or private benefit. The intent (or one intent) of the representatives of [redacted] in seeking a premature concession from the Service now is apparently to limit the taking of evidence on commercial practices. The

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6/(...continued)
Supreme Court (in cases which defined "trade or business not substantially related to tax-exempt purposes" for purposes of the unrelated business income tax, I.R.C. §§ 511-514). United States v. American College of Physicians, 475 U.S. 834 (1986) (advertising carried in professional journal); United States v. American Bar Endowment, 477 U.S. 105 (1986) (making insurance available to ABA members).

Service must see all the evidence before arriving at a non-commerciality conclusion. In addition, even if commerciality is not per se a disqualifying ground after all the evidence is in, we think the evidence should be in the record to support any finding of inurement or private benefit. In particular, a showing of private benefit must be supported by evidence that it is a "substantial" purpose of the organization. Of course, any amount of inurement is fatal to qualification under section 501(c)(3).

NEW ACTIVITIES

We understand that at least two additional activities are being pursued by [redacted] organizations which were not described heretofore in the court cases. One activity is a [redacted]. Such a system can evidence operation for a substantial commercial purpose; it can also evidence inurement. See People of God Community v. Commissioner, 75 T.C. 127 (1980); Senior Citizens of Missouri, Inc. v. Commissioner, T.C. Memo 1988-493; cf. World Family Corp. v. Commissioner, 81 T.C. 958 (1983), non-acq. 1984-2 C.B. 2.

The other activity [redacted] offering management courses to individuals or to unrelated [redacted]. While offering courses for a fee may not be in conflict with an organization's exempt purpose, the factors discussed herein may support a conclusion that the activity is in furtherance of a substantial commercial purpose.

Development of these (or other) areas in the examination may prove to be fruitful in establishing commerciality.

If we can be of further assistance, please advise. A copy of this formal tax litigation advice is being furnished to District Counsel, Atlanta, Brooklyn, Thousand Oaks and Washington, D.C.

MARLENE GROSS
Assistant Chief Counsel
(Tax Litigation)

By: _____
HENRY G. SALAMY
Chief, Branch No. 4
Tax Litigation Division

Attachment:
Letter dated July 8, 1988 (final adverse ruling).

cc: District Counsel, Atlanta
District Counsel, Brooklyn
District Counsel, Thousand Oaks
District Counsel, Washington, D.C.